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Remarks of  
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**"Energy Markets and The Environment:  
A New Era of Pragmatism?"**

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Policy Makers Working Together  
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Ladies and Gentlemen:

I.

I wish to thank you for allowing me to keynote this important conference. A national meeting at the intersection of two critical public policy issues -- America's energy future and the protection of its environment -- is timely and important. While Administrator Browner and I have developed a working relationship, it has been mostly inside the Congressional hearing room. My native habitat is the

economic regulatory precincts of pipeline certificate cases, wholesale electric rates and corporate mergers. But, I can assure you nevertheless that, personally speaking, no one is more attuned to the environment than a lame duck.

Those of us in energy regulation who authorize (to a lesser and lesser extent) the decisions of energy businesses and those of us whose agenda is primarily to arrest or change future patterns of energy development and fuel usage on behalf of the environment -- and there is plenty of cross-over between the two -- have increasing reasons to be talking to one another. This is, I suggest to you, a unique moment for us to be having this important conversation, for at least two reasons.

First, as we meet, the Nation's Presidential candidates are engaged in agenda-setting for the 21st century. This election season reflects a relatively

constructive turn of events. E.J. Dionne describes it  
this way:

The fundamental fact of politics in the year 2000 is a shift in the predominant mood. Politics is less ideological, and specifically less ideologically conservative, than it was in the late 1970s and 1980s. Attitudes toward government itself are still far less positive than they were in the early 1960s, before the cultural revolution, Vietnam, and Watergate. But philosophical hostility toward government has ebbed, replaced by a pragmatic inclination sympathetic to the expansion of public goods and in search of public action in spheres such as education, child care, health care, and the effort to right the balance between work and family life. (Brookings Review, Winter 2000, p. 10.)

I tend to subscribe to this evaluation. If I were to argue too strongly that pragmatism reigns supreme in Washington, however, my credibility with this audience would decline to zero. Perhaps this year's focus on serious issues -- Can we prolong the current prosperity

and close the gap between who it benefits and who it doesn't? How do we ensure the viability of Social Security? Can we rescue public education? -- portends real accomplishments in public policy in the coming years, as Americans once again come to expect government to do something constructive. I hope that is the case.

The other reason I find this conference so timely is what is suddenly back on the front page after a quarter century -- a renewed concern about energy production and consumption in this country. To the list of matters of national debate I just identified we should add, What direction must energy policy take? While our immediate preoccupation with electricity price spikes, rising natural gas and heating oil prices, and releases from the Strategic Petroleum Reserve might reduce to simple equations some very complicated, long term issues, the current "energy crisis" -- if I can call it that -- once again offers

us an opportunity to discuss with politicians and the public what an economically and environmentally sustainable energy future might look like.

I have argued lately that, because of changes in our economy's use of energy, the potential for meaningful restructuring of the electric industry, and the emergence of an efficient and competitive domestic natural gas market, this is not your father's energy crisis. Naturally, many of our citizens and businesses feel -- suddenly and quite understandably -- vulnerable to high prices for basic energy commodities. Yet, policymakers appear to me to be more confident that they are in a better position to control the market outcomes than we were in the 1970s. Some clearly believe that those solutions entail nothing more than increased development of conventional generation and transportation or transmission technologies, opening more lands and providing greater access to petroleum

reserves, building or re-powering more dams, and constructing more delivery infrastructure.

While that may certainly be part of it, especially in the near term, we can also use our existing resources better. Our interstate natural gas market, for example, is already equipped to respond more quickly to supply shortfalls and price run-ups than it was a decade or two ago. The very real advantage we hold over the bad old days involves the new energy technologies (many represented by today's participants), our sensitivity to strategic challenges like climate change, better markets for things like emissions credits and energy futures, recognition of the importance of managing the demand-side of the equation, the emergence of energy commodity e-commerce, and some steely-eyed realism after the Gulf War about the true cost of a barrel of oil. I think that we understand the trade-offs better and we have therefore

started the difficult journey toward sustainability as well as energy independence.

## II.

Today I want to focus on an important component of the recurrent "energy versus the environment" debate that always seems to leave policymakers clustered in opposing camps. Is the public interest best served by energy regulation or by free markets, by aggressive development and exploitation of mineral and hydrologic resources or resistance to it, by encouraging or discouraging energy consumption, and so forth? In a country that still guzzles energy, to use Sue Tierney's words, many of us are confident we know all the answers. It will nevertheless continue to be a challenging debate even for the best informed among us.

Let's focus on the troublesome, emerging markets for electricity. The hypothesis I want to put before you, from a regulator's perspective, is that an

efficient and competitive interstate bulk power market will make better environmental decisions than the heavily regulated monopoly environment we have lived with for more than a half century. I believe that new generation technologies, and therefore the environment, have an important stake in our ability to achieve electricity competition and consumer choice, to eliminate the benefits of vertical integration and transmission market power, and to reinvent the system to serve all sources of energy fairly and freely. This is not to argue that energy development and consumption is ever cost-free. But the pro-competitive agenda of the FERC can, I would contend, lead to some significant consumer and environmental benefits for the Nation, if and when we can get it implemented. What could be more pragmatically appealing than that?

Promoting competitive markets in electricity and promoting environmental quality are perfectly compatible goals. Few would regard the Commission as

an environmental regulator, although mitigating the adverse impacts of energy projects is part of our bread and butter. We very often resemble an antitrust agency these days, as well as a rate-setter. But, while the FERC's objectives are in most ways a function of its conventional energy regulatory mission, I believe we are coming to the realization that policies that are good for markets are also good for the environment. In most instances, those policy choices also have corollaries for state public service commissions.

We have already begun to achieve in wholesale electric markets some of the benefits that were previously obtained through our promotion of competitive natural gas markets. For instance, wholesale prices are beginning to decline on a real basis. Power markets contain more numerous and diverse participants and more competitive supply alternatives, and have begun to reverse the underinvestment in basic electricity infrastructure that threatens reliability.

Yet, without question, the skyrocketing prices in southern California reflect a politically and economically unsustainable market condition. The demand for power there and elsewhere has outstripped supply and complex probably market rules contributed to price volatility. Without supply alternatives, adequate information, or choice, San Diegans were only positioned to feel the pain of this industry transition instead of receiving the tangible benefits of competition. I cannot tell you how personally difficult and unsatisfying it is when regulators find themselves able to respond to Congressional and public alarm about the human impact of high energy prices with only clinical explanations about the market's evolution and recent supply and demand curves. Equally disheartening is the visceral inclination of many officials to blame these hardships on current efforts to change the electricity system, rather than on the failures of the past institutional arrangements. We should instead regard with dread the prospect of a

prolonged and tentative transition to workable  
electricity markets.

A longer perspective is important here. Let me identify the critical steps on the path to economic efficiency and real consumer benefits. Twenty years of proven non-utility generation was one. The advent of open access transmission under Order No. 888 was another. The Commission's efforts under Order No. 2000 to encourage better regional bulk power markets and to diminish transmission market power under Order No. 2000 was a third. These initiatives were punctuated and complemented by basic changes in electric utilities and scores of actions by state regulators to modernize the system. Few if any of these "accomplishments" has yet produced a completely workable market, but we have come a long way. We have also taken major steps toward environmental benefits, in the process, I would hasten to add.

Back in 1978, PURPA pointed us toward competition, new technologies, and greater efficiency in generation. It helped displace the central generation station model with renewables, cogeneration, and more benign natural gas generation. It opened market opportunities for distributed generation, often linked with thermal load and usually gas-fired. DG meant retail self-supply as well as price and reliability insurance and, because it can be located close to load, created fewer losses, and helped overcome transmission bottlenecks, it is prepared to make a contribution to system efficiency. So, the kind of open market envisioned in Order No. 888 -- while promising lower prices, more product choices, and new services -- also offers tremendous commercial opportunities for these resources and, consequently, major advantages for the environment.

No good deed is immediately rewarded, however. Soon after Order No. 888 in 1996, the Commission began to realize that the competitive bulk power markets it

sought to promote were not about to happen without fundamental change in the industry's structure -- changes that would diminish the power of incumbency and eliminate the operational impediments to large, transparent, and liquid markets for bulk power. Regional transmission organizations, or "RTOs," are the pre-conditions for the improved pricing, planning, and operations that I believe will have positive environmental consequences. Let me cite a few.

RTO formation. Order No. 2000 encourages market participants to engage in collaborative processes to develop RTOs. We think such processes will promote environmental goals, at least by ensuring that environmental and renewable resource considerations have a seat at the table during the discussion of market formation and the administrative approval processes. Such a forum to address market issues of special concern to the environmental community is unprecedented. Although I am more than aware that

current transmission owners would prefer the market to change on their terms, this kind of regional collaboration is in fact happening around much of the country -- for example, in the Pacific Northwest.

Moreover, we know that having a real-time balancing market that helps generators avoid penalties for missing schedules can be a significant benefit to certain kinds of renewable generators, given that they supply the market with power intermittently. A real-time balancing market is one of the functions that the Commission wants RTOs to develop.

Interconnection policy. The Commission is pursuing policies to facilitate generator interconnection with the transmission grid and thereby to buyers in the market. We want generators to be able to interconnect without enduring undue discrimination from the transmission owners and without bearing unfair

transaction cost burdens. Such a policy will help all new generators, and we expect that, as a result, newer, more efficient generators will displace increments of electrical generation from older central station plants, and generation from renewable resources and distributed generation will have greater commercial opportunities.

Market structure issues. The Commission has worked with, and will continue to work with, market participants to solve some of the market design problems that have plagued wholesale markets to date. One major market design problem that has significant implications for the environment is a lack of demand responsiveness. This is a key issue, given that the knee-jerk response to reliability and price problems is simply to build more plants. Open markets do encourage companies to compete for greater market share. However, markets can also balance the prospect of unlimited supply and load growth.

At the risk of over-generalization, the basic strategy of the environmental community in connection with electricity, during the Seventies, Eighties, and early Nineties, was least cost planning or demand-side management (DSM). The goal was to incorporate into decisions that regulators and generators were making about electricity supply, the notion that demand reduction has value in a market because it would help avoid unnecessary construction or use of generators. That strategy worked pretty well in some places, not so well in others. Often the means used were artificial adders or resource evaluation systems that tried to internalize the cost of environmental externalities.

As we contemplate new market structures, it is time we seriously evaluate the argument that competitive markets can accomplish these goals also, directly and without artificial means of valuation. I believe a

demand response should have value in the market and when energy users are not given a chance to change their usage or their suppliers in response to price, as was arguably the case in California recently, the immediate and long-term costs can be significant. Bid mechanisms, on the other hand, allow demand responses and can help recognize their importance. Users can either be paid for reducing demand or can receive reductions in prices. In other words, competitive markets may be able to achieve the environmental goals that we were trying to accomplish through DSM but without complex regulatory actions or the attendant controversy. Perhaps this can become the modern definition of least cost planning. We can reduce cost, make money, and help the environment.

In many markets, retail consumers cannot actively signal how much electricity they will demand at a given price. Even in jurisdictions that have opted for competition, the price signals to even major power

purchasers have been muffled by rate freezes or other artificial constraints. I would expect there to be a large "conservation effect" if more customers were to receive price signals on a real-time basis.

Consumers should be able to take informed actions to alter their behaviors to advance both their own self-interest and environmental quality. For example, they could forestall electricity use when prices are high, or make investments that shift to more efficient consumption patterns. Preserving demand as well as supply alternatives in a large regional market can help ensure reliability and avoid over-investments in peak shaving capacity -- the most problematic units to dispatch from an environmental perspective.

In addition, the "conservation effect" would diminish the chances that prices will soar during peak demand periods, because supply and demand would better come into balance.

I believe it is critically important that bid-based wholesale electric markets, such as those that have been created for California, and New England, New York, and the P.J.M. Interconnection sooner or later make demand-price responsiveness integral to their market clearing mechanisms. There are a number of ways that market design can be retooled to make this happen, but ultimately the opening of retail electric markets to competition and choice may be necessary.

Transmission pricing policy. A key objective of RTO development is the elimination of rate pancaking, a demonstrable benefit for remote resources and new market entrants. The Commission has also indicated its flexibility in experimenting with transmission pricing models as well. We know that renewable generators are concerned about the prospect of distance-sensitive transmission pricing. Renewables tend to be located far from load and therefore would pay higher transmission prices under a distance-sensitive model

than under a postage-stamp or license plate pricing model.

How an RTO prices congestion may also affect renewables because renewables generally will have less flexibility in where new facilities are located than will non-renewable resources. For these reasons, I believe it is critically important that all market participants have the opportunity to have their voices heard regarding RTO formation, especially when it comes to transmission pricing.

### III.

Wholesale and retail electricity policies are mutually dependent. A competitive wholesale market is a predicate for a competitive retail market. Conversely, without well-functioning retail markets designed to elicit good demand-price responses, wholesale markets will not operate optimally. Moreover, states will confront policy choices about

markets which are analogous to the choices FERC faces: interconnection policies, use of net metering, the availability of green power choices to the market, and the development of demand responsiveness in the market.

For that reason, state and federal regulators need to make this a common cause -- sometimes a difficult proposition, I recognize, when jurisdiction appears to be at stake.

Markets can help the environment -- specifically, efficient regional bulk power markets. But energy markets will do one more thing: they will change the regulator's job description forever. Recognizing that, the Commission reengineered itself over the past three years. In doing so, we adopted a Vision Statement that makes clear that promoting competition and protecting the environment are not mutually exclusive goals. I would like to think these objectives are integral to

both the Commission's culture and its values going forward. In any event, re-examining our role in economic development reenforced for me and many others the very valid proposition that energy and environmental issues are inseparable, both in our energy hungry society and in how we formulate our regulatory policies in response. To regard our energy needs and our environment's needs always as an either/or proposition leads invariably to wrong and even uneconomic decisions. We must all work to ensure that our efforts to develop markets for energy complement and are supported by environmentally sustainable options.

The Commission's core responsibility, as we move away from cost-of-service regulation, is to advance the cause of open markets and reliability. It will carry that mission forward, apparently without the anticipated Congressional action that could accelerate and confirm the Nation's progress toward competitive

markets. Our agenda for the coming year is therefore to create better market structures, while protecting ratepayers from the risks of this period of this industry transition. The Commission would like to do this with the full knowledge, cooperation, and support of state and federal agencies whose long-term mission it is to help make our energy economy a clean and sustainable enterprise. It will not be an easy job for any of us, but it will be part of what E.J. Dionne appropriately called that pragmatic inclination sympathetic to the expansion of public goods.

Thank you.